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In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 535

R. J. REYNOLDS TOBACCO COMPANY, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion, findings of fact, and conclusion of law of the Court of Claims (R. 1–71) [1] are reported at 149 F. Supp. 889.

JURISDICTION

The decision of the Court of Claims was entered on April 3, 1957. (R. 1.) Taxpayer's motion for rehearing was denied July 12, 1957. The petition for a writ of certiorari was filed on October 8, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1255 (1).

[1] Record references herein are to the appendix to taxpayer's petition for certiorari.

QUESTION PRESENTED

Whether the Court of Claims was warranted in concluding that payments from earnings and profits made by taxpayer to employee-shareholders proportionate to their stockholdings were not deductible under Section 23 (a) (1) (A), Internal Revenue Code of 1939, as amended, as reasonable compensation for services actually rendered.

STATUTE AND REGULATIONS INVOLVED

Sections 22 (a), 23 (a) (1) (A), and 115 (a) of the Internal Revenue Code of 1939, and Section 29.23 (a)–6 of Treasury Regulations 111, are set forth in the Appendix, *infra*, pp. 12–14.

STATEMENT

Taxpayer, a New Jersey corporation, is engaged in the manufacture and sale of tobacco products. (R. 16–17.) In each of the years 1940 to 1948, inclusive, pursuant to a company by-law enacted in 1912, it made certain payments from earnings and profits to its employee-shareholders in proportion to the employees' stockholdings in the company. (R. 30.) It is the deductibility of those payments that is in issue. (R. 54.)

The by-law provided for an annual payment in the discretion of the board of directors, up to 10 percent of profits in excess of those earned in 1910, to employees who both owned stock and had been employed for a full year, the payments to be made in proportion to the stock owned by each such employee. (R. 26.) The amounts so paid were in addition to the em-

ployees' regular salary. Also, taxpayer paid a regular dividend on its stock to all holders, regardless of employment. (R. 32.) The by-law was amended in 1915 to allow stock acquired during the year from another officer or employee or representative of a deceased employee to qualify for participation. Thereafter the by-law remained substantially unchanged until 1949 when participating Class A stock was frozen to those shares then in the hands of employees and a plan adopted to phase out the payments. (R. 26–27, 55.) By-law payments will cease in 1958. (R. 55.)

At the time the by-law was adopted only one class of stock, numbering 75,250 shares, was outstanding. As a result of various changes in capital structure, there was outstanding during the years 1940–1948, inclusive, 1,000,000 shares of Class A common stock and 9,000,000 shares of Class B common. At all times pertinent in this case, Class B common stock had the same rights as Class A common except that Class B stockholders were not eligible for participation under the by-laws and had no voting rights. (R. 22.)

The court below found (R. 8–9) that "The purpose of the plan was obviously to encourage employees to become owners of a share of the business" so that they, "by reason of such ownership, would have a greater interest in its profitable operations and would give their best efforts to that end." Thus, the by-law was designed to provide a plan for profit participation as an incentive to employees. (R. 70.). However, in operation the plan rewarded employees who held Class A common stock with payments from annual profits

in large part because of their investments in such stock and not purely for services. (R. 70.) "As originally planned, [taxpayer] wanted only those employees 'who had the interest of the company at heart' to participate" and the plan was supervised by a company committee with this in mind. (R. 4.) While it was taxpayer's desire that participating stock should not be acquired without company approval, there was no corporate resolution concerning the manner or method under which acquisition could be made or the amount one employee could acquire. No employee was ever discharged for acquiring too much stock. In the early days of the plan, taxpayer's founder financed purchases; until 1933 taxpayer extended credit. Because of Securities and Exchange Commission rules, taxpayer has not bought its own stock for resale to employees since 1935. Employees could acquire the eligible stock by gift, exchange, purchase from other employees and holders of the stock, or purchase on the Stock Exchange, sometimes without notice to the company. (R. 4–5.) Some employees bought all of the stock they could and others, who had an opportunity to buy, did not do so for personal reasons. (R. 33–36.) In management's view, these imperfections did not affect the overall success of the plan. (R. 5.)

Payments were determined under the by-law solely on the basis of stockholding without regard to position or actual service rendered. (R. 9.) Fixed salaries of some classes of employees were found to be at the going rate in the community; others were low in comparison to competitors. (R. 5.) While four of

taxpayer's officers testified that they had reviewed the records of participating employees and all were reasonable with certain conceded exceptions, no comparative evidence was given. As to the officer-director group, comparative testimony was given, but it related only to the aggregate compensation of the group and did not directly compare the rates of compensation with those of competitors with reference to the duties and responsibilities of individual officers or directors. (R. 5–6, 13–14.)

Historically, through the years at issue and until 1949, taxpayer treated the by-law payments as dividends. (R. 10.)

ARGUMENT

1. It is submitted that the decision below that the payments to employee-shareholders were dividends rather than compensation is correct, presents essentially a factual question, and is not in conflict with any decision of this Court or with any other appellate decision.

While the motive in adopting the by-law which gave rise to the payments in issue may have stemmed from management's desire to develop in the employees a greater interest in the corporation, the effect of the operation of this by-law from 1940 to 1948, inclusive, was to reward employees, who held Class A common stock, with payments from annual profits in large part because of their capital investment in such stock, and not purely for services.

The payments were made pro rata to employee stock holdings, irrespective of the employee's fixed salary, the salary of others similarly situated, or the con-

tinued worth of the employee's services. The corporation sold no stock from 1935 and the employees could acquire stock without corporate approval from third parties or through the Stock Exchange and qualify for profit participation. Some employees acquired all the stock they could. Others, for personal reasons, bought none.

Section 23 (a) (1) (A) (Appendix, *infra*, p. 12) allows deduction of all ordinary and necessary expenses paid or incurred "including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *." Section 29.23-(a)-6, Treasury Regulations 111 (Appendix, *infra*, pp. 13–14) governing the years 1942 to 1948, inclusive, provides that in order to be deductible as compensation the payments must be based purely on services rendered. Treasury Regulations 103, Section 19.23 (a)-6, governing the years 1940 and 1941, is similar.[2]

[2] The applicable provisions of Section 29.23(a)-6 of Regulations 111 above cited have appeared in all Treasury Regulations since 1921 construing sections of the Revenue Acts containing similar provisions. See Article 105, Regulations 45 (1920 ed.); Art. 105, Regulations 62, promulgated under the Revenue Act of 1921; Article 106, Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926, respectively; Article 126, Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932, respectively; Article 23(a)-6, Regulations 86, 94 and 101, promulgated under the Revenue Acts of 1934, 1936, and 1938, respectively. It is well settled that Regulations which have continued in force substantially unchanged through successive reenactments of the statutory provisions to which they pertain must be regarded as having received Congressional approval. *Lykes* v. *United States*, 343 U. S. 118, rehearing denied, 343 U. S. 937; *Commissioner* v. *Wheeler*, 324 U. S. 542; *Morrissey* v. *Commissioner*, 296 U. S. 344.

The court below noted by numerous illustrations (R. 10–11) that taxpayer historically and through the years at issue treated the by-law payments as dividends. While not binding, these illustrations are certainly indicative of taxpayer's intent and their consideration by the Court of Claims as a pertinent factor is certainly permissible. Indeed, in answer to a stockholder's derivative suit charging that the participation payments when combined with fixed salaries resulted in excessive compensation, taxpayer alleged the payments were dividends, and the court so held. *Bookman* v. *R. J. Reynolds Tobacco Co.*, 138 N. J. Eq. 312.[1]

The question whether payments made to one enjoying the dual capacity of employee and stockholder are dividends or compensation must turn on the facts of the case and the holding that payments proportioned to stockholdings are dividends and are not compensation is not new. See *Twin City Tile & Marble Co.* v. *Commissioner*, 6 B. T. A. 1238, dismissed, 32 F. 2d 229 (C. A. 8th); *Marble & Shattuck Chair Co.* v. *Commissioner*, 13 B. T. A. 657, affirmed, 39 F. 2d 393 (C. A. 6th); *Doernbecher Mfg. Co.* v. *Commissioner*, 95 F. 2d 296 (C. A. 9th); and *Bridges-Smith Co.* v. *Glenn* (W. D. Ky.), decided March 18, 1939 (24 A. F. T. R. 1212), affirmed *per curiam*, 116 F. 2d 934 (C. A. 6th).

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[1] As recited by the court, taxpayer contended as follows: "They assert that the amounts payable under the by-law had three characteristics: (1) they were payable only out of profits; (2) they were payable only as an extra dividend on stock owned by an employee; and (3) in proportion to the stock owned." 138 N. J. Eq. at 384.

Despite taxpayer's assertion to the contrary, it is submitted that the holding below is not in conflict with this Court's decision in *Commissioner* v. *LoBue*, 351 U. S. 243, rehearing denied, 352 U. S. 859. The question in that case was whether income was to be recognized upon the transfer of property (stock) to an employee at less than fair market value. The lower courts had held, that as the stock options were primarily intended to provide the employee with a proprietary interest in the corporation, their exercise did not result in present gain. This Court held that this interpretation of Section 22 (a) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 12) was too narrow. Thus, the issue in *LoBue* was whether the exercise of the option resulted in a gift or compensation, whereas the issue here is whether the payments are compensation or dividends.

The issue in *Commissioner* v. *LoBue* arose upon the acquisition of stock, whereas here the question involves the nature of subsequent payments to the stockholder. The receipt of income here requires a dual status (that the recipient be both a stockholder and employee) whereas prior to receipt of income it was necessary only that Mr. LoBue be an employee. Therefore, no dividend question could have been involved under the facts in that case.

Further, there was no suggestion in *Commissioner* v. *LoBue* that, because the stock was acquired as compensation, subsequent payments thereon would be compensation rather than dividends even though the benefit to the corporation from establishment of a proprietary interest in the employee continues as

long as his dual status as stockholder and employee lasts.

The Tax Court in a case involving this taxpayer for later years (1949–1950) held some part of the by-law payments there involved deductible as reasonable compensation. *R. J. Reynolds Tobacco Co.* v. *Commissioner,* decided July 6, 1956 (1956 P-H T. C. Memorandum Decisions, par. 56, 161). Final decision was entered by the Tax Court on October 15, 1957. While we believe that decision to be wrong, as noted by the court here below (R. 15):

> * * * the [Tax] court in that case was deciding the nature of the payments made pursuant to a different bylaw, on a different record, and for different years than the ones in question here.

2. As a second and independent ground for denying taxpayer's refund claim, the Court of Claims held that assuming, *arguendo,* that the payments were compensation, the taxpayer has failed to establish the reasonableness thereof.* Taxpayer's complaint seems to be, in short, that the decision is contrary to the evidence.

Section 23 (a) (1) (A) includes among deductible business expenses a "reasonable allowance" for compensation for personal services. Deductions are a matter of legislative grace and the burden of establishing one's right thereto is on the taxpayer. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590; *Deputy* v. *duPont,* 308 U. S. 488, 493; *New Colonial*

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* Two judges concurred on the first issue but refrained from passing on the issue of reasonableness. (R. 16.)

Co. v. *Helvering*, 292 U. S. 435, 440. A salary deduction will be disallowed unless its reasonableness is clearly proved. *L. E. Pinkham Med. Co.* v. *Commissioner*, 128 F. 2d 986 (C. A. 1st), certiorari denied, 317 U. S. 675. While the Commissioner believed the payments to be dividends rather than compensation, this did not relieve taxpayer of the normal burden of establishing his right to the claimed deduction; *i. e.*, not only that the payments were compensation but also that they were reasonable. Significantly, the objections which the Court of Claims found with the probative value of the testimony of taxpayer's officers and the comparative data produced likewise led the Tax Court, in its consideration of later years, to consider this evidence inadequate to establish reasonableness. *R. J. Reynolds Tobacco Co.* v. *Commissioner, supra.* While the Tax Court, on the record before it, came up with a formula of its own by applying the principles of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. A. 2d),[5] the Court of Claims found it was unable to de-

[5] In that case taxpayer, a well-known entertainer, had been denied any allowance for entertainment and travel expense because he had failed to itemize or detail his expenses. Holding that it was clear that some amounts were spent and that absolute certainty in such matters was usually impossible, the Court of Appeals ordered the trial court to make an approximation, bearing heavily if it chose on the taxpayer whose inexactitude was of his own making. But this does not compel the trier of the fact to make an uninformed, wholly insupportable guess. As stated in *Williams* v. *United States*, 245 F. 2d 559, 560 (C. A. 5th):

> For the basic requirement is that there be sufficient evidence to satisfy the trier that *at least* the amount allowed in the estimate was in fact spent or incurred for the stated purposes. Until the trier has that assurance from the record, relief to the taxpayer would be unguided largesse.

vise any such formula. Cf. *L. Schepp Co.* v. *Commissioner*, 25 B. T. A. 419, 429–430.

Of course, the fact that the amount of payments to some employees was small, does not of itself prove reasonableness, for the measure of reward under the plan was stockholding rather than actual service rendered. Further, as some stock was acquired without the company's approval through purchase, gift, or inheritance, no intent to compensate could be inferred from payment.

The various appellate cases cited (Pet. 17) with which conflict is alleged are simply a group of cases, predicated on a variety of factual settings where appellate courts have reversed a trial court's holding as being clearly erroneous, where the lower court had disregarded uncontroverted opinion testimony. None poses a conflict in principle with the instant case and none involved a situation of employee-stockholders receiving payments exactly in proportion to their stockholdings without reference to the extent or value of their services.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1957.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 23 [As amended by Section 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23 (a)–6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings

of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services but in part constitute payment for the transfer of their business.

* * * * *

Section 19.23 (a)–6, Treasury Regulations 103, promulgated under the Internal Revenue Code of 1939, applicable for the years 1940–1941, contains like provisions.